

Private Letter Ruling: A partner is entitled to the portion of the film production services credit shown on the final certificate issued by DCEO that is allocated to it by the partnership agreement.

January 17, 2006

Dear:

This is in response to your letter dated January 4, 2006, in which you request a Private Letter Ruling on behalf of CORPORATION. Review of your request for a Private Letter Ruling disclosed that all information described in paragraphs 1 through 8 of subsection (b) of 86 Ill. Adm. Code Section 1200.110 appears to be contained in your request. The Private Letter Ruling will bind the Department only with respect to CORPORATION for the issue or issues presented in this ruling. Issuance of this ruling is conditioned upon the understanding that neither CORPORATION nor a related taxpayer is currently under audit or involved in litigation concerning the issues that are the subject of this ruling request.

The facts and analysis as you have presented them are as follows:

The purpose of this letter is to request a private letter ruling from the Illinois Department of Revenue (the "Department") in accordance with 2 Ill. Adm. Code § 1200.110. CORPORATION, a Delaware corporation ("CORPORATION") is seeking a ruling that CORPORATION, pursuant to section 213 of the Illinois Income Tax Act, will be entitled to a credit against the Illinois Income Tax in an amount determined by the Department of Commerce and Economic Opportunity ("DCEO") under the Film Production Services Tax Credit Act.

#### BACKGROUND

COMPANY1 LLC, a California limited liability company ("Production Company"), was organized by COMPANY2, LLC, a Delaware limited liability company, (formerly known as COMPANY3, LLC) ("Studio"), in connection with the full-length motion picture tentatively entitled "MOTION PICTURE" which commenced principal photography in the State of Illinois on or about April 25, 2005 (the "Production"). At the time of the formation of Production Company, Production Company was wholly owned by Studio. As a result of employing Illinois residents for services rendered for the Production, Production Company will generate Illinois income tax credits ("Credits") allowable under the Film Production Services Tax Credit Act (the "Film Credit Act," 35 ILCS 15/1 *et seq.*). The amount of the Credits will be determined based on the qualified "Illinois Labor Expenditures," as defined in Section 528.20 of the regulations issued by DCEO pursuant to the Film Credit Act (the "Film Credit Regulations," 47 Ill. Admin. Code § 528.210 *et seq.*), incurred in connection with the Production and as approved by DCEO (the "Production Expenditures"). The Production Expenditures were incurred by Production Company in 2005. The amount of such Credits will be set forth on the "Final Film Tax Credit Certificate," as defined in the Film Credit Regulations, issued by DCEO to Production Company.

CORPORATION, an indirect subsidiary of COMPANY4, is a Delaware corporation that will have Illinois Income Tax liability in its taxable year ending December 31, 2006.

Pursuant to a letter agreement dated as of December 21, 2005 (the "Agreement"), between CORPORATION and Production Company, CORPORATION agreed to acquire a special membership interest (the "Special Interest") in Production Company in connection with the Production and the Credits associated therewith. The Agreement is attached hereto as Exhibit A, and the factual description and other terms contained therein are incorporated by reference in this letter.

Subject to the terms and conditions contained in the Agreement, CORPORATION intends to acquire, before January 10, 2006 (the "Closing Date"), the Special Interest representing a .01 percent interest in Production Company. As consideration for the Special Interest, CORPORATION will pay to Production Company an amount equal to the sum of one hundred dollars (\$100.00) plus eighty-five percent (85%) of the amount of the Credits set forth in the Final Film Tax Credit Certificate. CORPORATION will retain the Special Interest through the last day of the current taxable year of Production Company (the "2006 Tax Year"), which is expected to occur on or about January 24, 2006, when Studio will acquire the Special Interest from CORPORATION. Under the normal operation of federal tax law, the partnership which exists for tax purposes in the form of the Production Company (see CORPORATION's representations nos. 1 and 3, below) will terminate as a partnership for tax purposes when all of its interests are again owned by Studio. Treas. Reg. § 301.7701-3(b)(1)(ii); Treas. Reg. § 1.708-1(b)(1). On the date the partnership so terminates, the partnership taxable year will close with respect to all partners. Treas. Reg. § 1.708-1(b)(3). Thus, the last day of the 2006 Tax Year will occur on the date when CORPORATION conveys its Special Interest to Studio. Studio intends to continue Production Company as a wholly-owned limited liability company thereafter.

CORPORATION intends to sell its Special Interest to Studio for an amount equal to the fair market value of the Special Interest. As defined in the Agreement, "fair market value" means the value of the Special Interest as reflected in any bona fide third party offer to purchase the Special Interest or, in the absence of any such offer, the liquidated fair market value of one hundred dollars (\$100.00), which CORPORATION and Studio have determined approximates the fair market value of the Special Interest as of the expected purchase date on or about January 24, 2006. Pursuant to the terms of an amendment to the operating agreement of Production Company (as amended, the "Operating Agreement"), Production Company will allocate to CORPORATION 100% of the amount of the total Credits shown on the Final Film Tax Credit Certificate and will issue to CORPORATION a Schedule K-1-P (or its equivalent), together with a copy of the Final Film Tax Credit Certificate, in order to enable CORPORATION to claim the Credits in its taxable year ending December 31, 2006. The terms of the Operating Agreement will also allocate to CORPORATION the production expenses associated with the Production, up to the amount of CORPORATION's capital contribution in Production Company.

In addition to the facts described above and set forth in greater detail in the Agreement, CORPORATION represents to you as follows:

1. Production Company will elect to be treated as a partnership for federal income

tax purposes.

2. To the best of its knowledge, DCEO will issue a Final Film Tax Credit Certificate to Production Company during the 2006 Tax Year.
3. CORPORATION will be a partner, for federal income tax purposes, in Production Company through the end of the 2006 Tax Year.
4. The Operating Agreement will allocate 100% of the amount of the Credits set forth on the Final Film Tax Credit Certificate to CORPORATION.

#### RULING REQUESTED

Taxpayer respectfully requests that the Department rule that CORPORATION, pursuant to section 213 of the Illinois Income Tax Act (the "IITA," 35 ILCS 5/101 *et seq.*), will be entitled to a credit against the Illinois Income Tax (the "Income Tax," 35 ILCS 5/201(a) and (b)) in an amount determined by DCEO under the Film Credit Act and as set forth on the Final Film Tax Credit Certificate issued to Production Company in its taxable year ending December 31, 2006.

#### DISCUSSION

##### Overview of the Credit

The Income Tax is imposed on a corporation at the rate of 4.8% of the corporation's net income for the taxable year. 35 ILCS 5/201(a) and (b). "Net income" is defined as the taxpayer's "base income" allocated or apportioned to Illinois. 35 ILCS 5/202. A corporation's "base income" is its federal taxable income, subject to certain enumerated modifications. 35 ILCS 5/203(b).

Effective January 1, 2004, the Film Credit Act empowers DCEO to make awards of the Credits for the purpose of preserving and expanding the motion picture industry in Illinois and to promote and encourage the hiring of Illinois residents representing the diversity of the state population. 47 Ill. Admin Code § 528.10. Section 213 of the IITA provides, *inter alia*:

For tax years beginning on or after January 1, 2004, a taxpayer who has been awarded a tax credit under the Film Production Services Tax Credit Act is entitled to a credit against the taxes imposed under subsections (a) and (b) of Section 201 of this Act in an amount determined by the Department of Commerce and Community Affairs under the Film Production Services Tax Credit Act. If the taxpayer is a partnership or Subchapter S corporation, the credit is allowed to the partners or shareholders in accordance with the determination of income and distributive share of income under Sections 702 and 704 and Subchapter S of the Internal Revenue Code.

35 ILCS 5/213. The IITA delegates to DCEO the authority to prescribe rules to enforce

and administer the provisions of the Film Credit Act. 35 ILCS 5/213.

The Film Credit Regulations provide that eligible applicants for the Credit will be awarded a Credit equal to 25% of the Illinois labor expenditures approved by DCEO for an "Accredited Production." 47 Ill. Admin. Code § 528.70. Upon approval of an initial application for the Credit, DCEO will issue an "Interim Accredited Production Certificate" certifying that the production is an "Accredited Production" that meets the guidelines of the Film Credit Act, and will set forth the anticipated amount of the Credit. 47 Ill. Admin. Code § 528.80. DCEO then issues a Final Film Tax Credit Certificate "upon [DCEO's] verification that the Applicant is in compliance with all requirements of the Act and the administrative rules relative to the award of the Credit, including verification of all costs submitted as qualifying as the Applicant's Illinois Labor Expenditures." 47 Ill. Admin. Code § 528.80(b). To qualify as "Illinois Labor Expenditures," salary or wage expenditures must be "[p]aid in the tax year for which the applicant is claiming the credit or no later than 60 days after the end of the tax year." 47 Ill. Admin. Code § 528.20. Under the Film Credit Regulations, rescission of the Credit by DCEO, or the institution of proceedings to have the credit revoked, may result only in the event of "[m]aterial noncompliance" with the requirements of the Interim Accredited Production Certificate. 47 Ill. Admin. Code § 528.90. The Credits allowed under the Film Credit Act must be taken in the taxable year in which the Final Film Tax Credit Certificate is issued by DCEO. 86 Ill. Admin. Code § 100.2185. The duration of the Credit may not exceed one taxable year. 47 Ill. Admin. Code § 528.70(c).

The Film Credit Regulations provide that "[a]n applicant that is not an Illinois taxpayer (and has no Illinois income tax liability) may utilize one of [several] structures in order to be eligible for the Credit," including establishing "a partnership or an LLC for purposes of accomplishing the production." 47 Ill. Admin. Code §§ 528.30(b); 528.30(b)(1). The Film Credit Regulations further provide:

If the taxpayer is a partnership or Subchapter S corporation, the credit is allowed to the partners or shareholders in accordance with the determination of income and distributive share of income under Sections 702 and 704 and Subchapter S of the Internal Revenue Code. [26 U.S.C.A. 702 and 704]. The credit may not be carried forward or back. In no event shall a Credit under this Act reduce the taxpayer's liability to less than zero. [35 ILCS 5/213].

47 Ill. Admin. Code § 528.70(a). Under the Act, a limited liability company that is treated as a partnership for federal income tax purposes is also treated as a partnership for Illinois tax purposes. 35 ILCS 5/1501(a)(4) and (16). Section 704 of the Internal Revenue Code of 1986, as amended (the "IRC" or the "Code"), provides that a partner's distributive share of income, gain, loss, deduction, or credit (or items thereof) is determined in accordance with the partner's interest in the partnership (determined by taking into account all the facts and circumstances), if (i) the partnership agreement does not provide for the partner's distributive share of income, gain, loss, deduction or credit (or items thereof) or (ii) the allocation to a partner under the agreement of such items does not have "substantial economic effect." IRC § 704(a)-(b).

The regulations issued under the Code (the "Treasury Regulations" or "Treas. Reg."), provide that in general, an allocation contained in a partnership agreement will be respected if it meets one of three tests: (1) it has substantial economic effect; (2) it is in accordance with the partners' interest in the partnership; or (3) the allocation is "deemed" to be in accordance with the partners' interests in the partnership pursuant to one of the special rules of the Treasury Regulations. Treas. Reg. §1.704-1(b)(1)(i). The Treasury Regulations describe specific requirements that must be met for an allocation to have "economic effect," which are based on the principle that the allocation "must be consistent with the underlying economic arrangement of the partners. This means that in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden." Treas. Reg. § 1.704-1(b)(2)(ii). A partner's interest in the partnership is generally reflected by the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated. Treas. Reg. § 1.704-1(b)(3)(i). The factors to be considered in determining a partner's interest in a partnership include: (a) the partners' relative contributions to the partnership; (b) the interests of the partners in economic profits and losses (if different than taxable income or loss); (c) the partners' interests in cash flow and other non-liquidating distributions; and (d) the rights of the partners to distributions of capital upon liquidation. Treas. Reg. § 1.704-1(b)(3)(ii).

The Treasury Regulations provide generally that, because allocations of tax credits are not reflected by adjustments to the partners' capital accounts, they cannot have economic effect and such credits must be allocated in accordance with the partners' interest in the partnership as of the time the tax credit or credit recapture arises. Treas. Reg. § 1.704-1(b)(4)(ii). However, with respect to tax credits (other than the investment tax credit):

if a partnership expenditure (whether or not deductible) that gives rise to a tax credit in a partnership taxable year also gives rise to valid allocations of partnership loss or deduction (or other downward capital account adjustment) for such year, then the partners' interests in the partnership with respect to such credit (or the cost giving rise thereto) shall be in the same proportion as such partners' distributive shares of such loss or deduction (and adjustments).

Treas. Reg. § 1.704-1(b)(4)(ii).

#### Application of Law to CORPORATION

To the best of the knowledge of CORPORATION, DCEO will issue a Final Film Tax Credit Certificate to Production Company during the 2006 Tax Year. The issuance of such certificate certifies that Production Company has complied with all requirements of the Film Credit Act and the Film Credit Regulations and that it is entitled to a Credit under the Film Credit Act in the amount shown on the certificate.

Production Company, as a limited liability company, is a valid structure under the Film Credit Regulations for purposes of accomplishing an accredited production. See 47 Ill. Admin. Code § 530.30(b)(1). We have represented to you in this letter that Production Company will elect to be treated as a partnership for federal tax purposes and that CORPORATION is a partner in Production Company for federal income tax purposes. Accordingly, the Credits are allowed to the partners of Production Company in accordance with the determination of income and distributive share of income under Sections 702 and 704 of the Code. See 47 Ill. Admin. Code § 528.70(a).

In permitting partners in a partnership to specially allocate certain items of income or loss in a manner disproportionate to their interests in the partnership, the federal rules recognize the flexibility of the partnership form in accommodating different economic arrangements. The Film Credit Regulations specifically endorse the use of the partnership form where a production company (which may not be an Illinois taxpayer) producing a film in Illinois may agree to partner with an entity with Illinois tax liability to apply for the Credit, and to allocate the Credit to the Illinois investor in exchange for monetary compensation in the form of a cash contribution to the partnership.

While allocations of tax credits are viewed as lacking economic effect within the meaning of Section 704 of the Code, an allocation is valid if the credit is allocated in the same proportion as the expenses that gave rise to the credit, and the allocation of those expenses has substantial economic effect. Treas. Reg. § 1.704-1(b)(4)(ii). Given that the parties have structured Production Company to enable the Credits generated by the Production to be utilized by CORPORATION, an Illinois taxpayer, in consideration for its cash investment in Production Company, and that the Operating Agreement will allocate the production expenses associated with the Production to CORPORATION (to the extent of its capital contribution in Production Company), in our view, the allocation of the Credits to CORPORATION is within the spirit of the provisions of Section 704 of the Code<sup>1</sup> and thus satisfies Section 528.70(a) of the Film Credit Regulations.

As a result, CORPORATION should be entitled to a credit against the Illinois Income Tax for its taxable year with which or within with[sic] the 2006 Tax Year ends,<sup>2</sup> in the amount of the Credits allocated to Production Company.

#### CONCLUSION

Taxpayer respectfully requests that the Department rule that CORPORATION will be entitled to a Credit pursuant to Section 213 of the IITA against its Illinois Income Tax for its taxable year ending December 31, 2006, equal to 100% of the amount determined by DCEO and as set forth on the Final Film Tax Credit Certificate issued to Production Company.

#### REQUIRED STATEMENTS

1. The tax period at issue is the taxable year of CORPORATION ending December 31, 2006.

2. No audit or litigation regarding this tax period or the issues presented is pending with the Department.
3. To the best of the knowledge of both the CORPORATION and the undersigned, (i) the Department has not previously ruled on the same or a similar issue of the taxpayer or a predecessor and (ii) neither CORPORATION nor any representative has previously submitted the same or a similar issue to the Department and withdrawn it before a letter ruling was issued.
4. Favorable and contrary authorities have been discussed above.
5. A Power of Attorney has been executed by CORPORATION and is attached hereto as Exhibit B.

### **Ruling of the Department**

You have represented that the Department of Commerce and Economic Opportunity will issue a Final Film Tax Credit Certificate to COMPANY1 LLC prior to the close of its taxable year anticipated to end January 24, 2006; that the Final Film Tax Credit Certificate will show a specific amount of film production services credit earned by COMPANY1 LLC; that COMPANY1 LLC will elect to be treated as a partnership for federal income tax purposes; that CORPORATION will be a partner in COMPANY1 LLC through the end of the taxable year of COMPANY1 LLC anticipated to end January 24, 2006; and that the partnership agreement of COMPANY1 allocates 100% of the film production services credit earned by COMPANY1 to CORPORATION. Based on these representations, CORPORATION will be entitled to claim on its Illinois income tax return for its taxable year ending December 31, 2006, the entire amount of the film production services credit shown on the Final Film Tax Credit Certificate issued to COMPANY1 LLC, provided that the credit may not reduce the Illinois income tax liability of CORPORATION below zero. In making this ruling, we wish to make clear that we do not agree with the legal analysis in footnote 1 of your request regarding the provision in Section 213 of the Illinois Income Tax Act that a credit earned by a partnership shall be allowed to the partners of the partnership only in accordance with the distributive shares of the partners under Section 704 of the Internal Revenue Code.

The facts upon which this ruling are based are subject to review by the Department during the course of any audit, investigation or hearing and this ruling shall bind the Department only if the material facts as recited in this ruling are correct and complete. This ruling will cease to bind the Department if there is a pertinent change in statutory law, case law, rules or in the material facts recited in this ruling. Pursuant to 2 Ill. Admin. Code Section 1200.110(e), this ruling is automatically revoked as of ten years after the date of issuance, if not revoked earlier.

Very truly yours,

Paul Caselton  
Deputy General Counsel -- Income Tax

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<sup>1</sup> Even if the allocation did not meet the technical requirements of the Code, the full amount of the Credits should be allowable to CORPORATION to facilitate the policy underlying the Film Credit Act of encouraging filmmaking—a business often undertaken by non-Illinois taxpayers—in Illinois. To mandate strict compliance with the rules of Section 704 would vitiate the clear intent of the Illinois Legislature to make the Credits utilizable by applicants that do not have Illinois income tax liability. See § 528.30(b).

<sup>2</sup> The Production Expenditures were paid in 2005, which is no later than 60 days after the end of the 2006 tax year in which the Credits are being claimed. See 47 Ill. Admin. Code § 528.20. The Credits will be taken in the taxable year in which the Final Film Tax Credit Certificate is issued by DCEO (2006), in accordance with 86 Ill. Admin. Code § 100.2185.